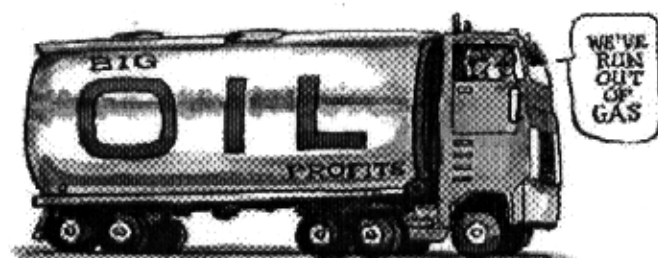


CHEAP OIL

The next shock?



The price of oil has fallen by half in the past two years, to just over \$10 a barrel. It may fall further—and the effects will not be as good as you might hope

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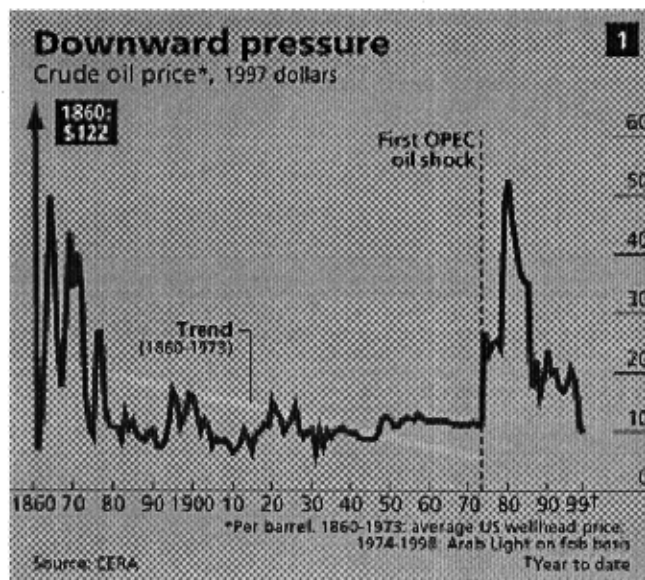
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OIL is cheaper today, in real terms, than it was in 1973. After two OPEC-induced decades of expensive oil, oil producers and the oil industry as a whole have more or less given up hope that prices might rebound soon. The chairman of Royal Dutch/Shell, Mark Moody-Stuart, three months ago unveiled a five-year plan that assumed a price of \$14 a barrel. He has since publicly mused about oil at \$11. Sir John Browne, chief executive of BP-Amoco, is now working on a similar assumption.

Consumers everywhere will rejoice at the prospect of cheap, plentiful oil for the foreseeable future. Policymakers who remember the pain of responding to oil shocks in 1973 and in 1979-80 will also be pleased. But the oilmen's musings will not be popular with their fellows. For if oil prices remain around \$10, every oil firm will have to slash its exploration budget. Few investments outside the Middle East will any longer make sense.

Cheap oil will also mean that most oil-producing countries, many of them run by benighted governments that are already flirting with financial collapse, are likely to see their economies deteriorate further. And it might also encourage more emissions of carbon dioxide at just the moment when the world is trying to do something about global warming.

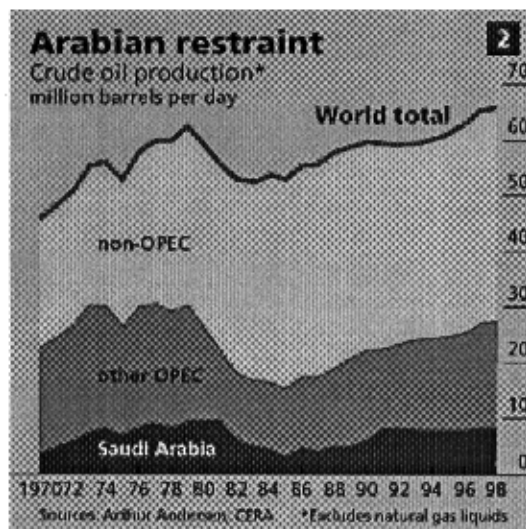
Yet here is a thought: \$10 might actually be too optimistic. We may be heading for \$5. To see why, consider chart 1. Thanks to new technology and productivity gains, you might expect the price of oil, like that of most other commodities, to fall slowly over the years. Judging by the oil market in the pre-OPEC era, a "normal" market price might now be in the \$5-10 range. Factor in the current slow growth of the world economy and the normal price drops to the bottom of that range.



That the recent fall in prices has been so precipitous merely confirms that, for the past 25 years, oil has been anything but a normal commodity. Although the Middle East contains two-thirds of the world's proven oil reserves, it produces less than a third of the world's oil. If production were determined by cost and quality alone, most oil would come from these countries. Oil in the Gulf is cheap to extract—barely \$2 a barrel, a quarter of the cost in the North Sea. Unlike the heavy crudes of Mexico or Venezuela, it is of high quality and high value. Much of the world needs fancy technology and expensive rigs to extract oil; in Arabia, as the old hands say, “you just stick a straw in the ground and it gushes out.”

The Gulf countries are to blame for their small share of the market. By nationalising their oil industries and doing their best through the OPEC cartel to keep prices high in the 1970s and 1980s, they encouraged oil development elsewhere. With oil so profitable, prospectors searched inhospitable parts of the world. The perverse result is that high-cost regions (such as the North Sea) have been exploited before low-cost ones (such as Iran).

The oil industry is like a ship with its centre of gravity above the water line, says Jeremy Elden of Germany's Commerzbank. It can sail smoothly for years, but capsize suddenly in rough seas—and do so quite rapidly. An unprecedented combination of excess supply and weak demand has created just such rough seas in the past year. The finances of the Gulf states are suffering, as budget cutbacks and recent talk of defence cancellations have shown.



Yet if the Gulf producers thought that oil prices would remain low for some years, it would pay them to abandon all attempts to boost oil revenues by propping up prices, and instead to increase production. The result would be a world in which supply and demand were determined not by geopolitics and cartels, but by geology and markets—meaning that, in today's conditions, the price would head down towards \$5. That sounds appealing. But it carries also a less happy corollary of a world that depends upon a highly unstable region for half its oil, with the proportion rising all the time.

Well down

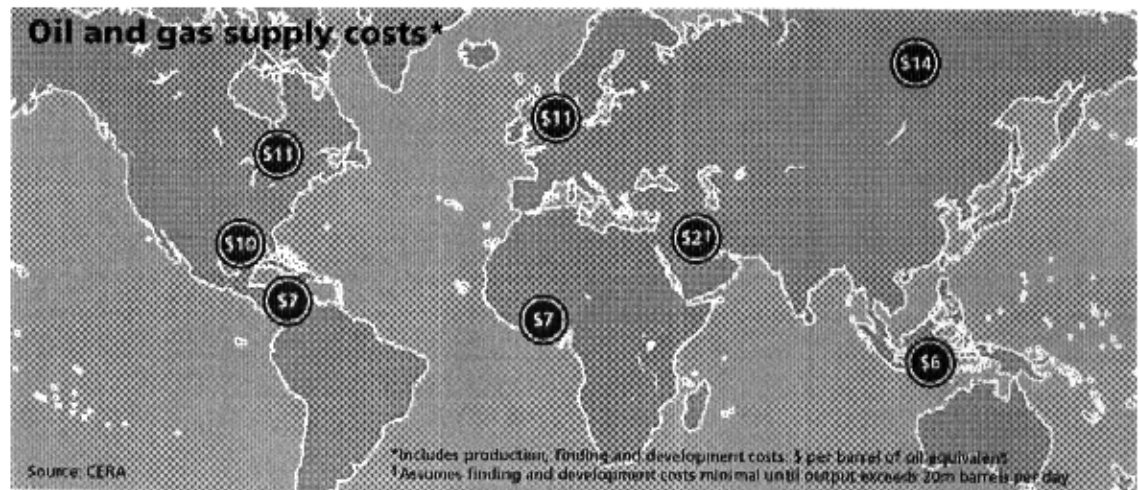
A new report by Arthur Andersen, an accounting firm, and CERA, an energy consultancy, argues that the present price collapse is fundamentally different from the previous one, in 1986. Then, high prices had choked off demand; but as soon as oil became cheap again, the thirst for it returned. This time demand has barely picked up, even though the price has fallen by half.

One short-term reason is yet another unseasonably warm winter in the northern hemisphere. A more lasting one is the economic troubles of Asia, the region that had been expected to drive oil-company profits for years to come. Even such sceptics as David O'Reilly, one of Chevron's bosses, who continues to pooh-pooh what he calls a temporary "price siege", still worry that, because of Asia's crisis, demand might not rebound. Demand may fall further if and when America's record-breaking growth comes to an end.

There is another threat on the demand side: worries over global warming. Although the science remains inconclusive, rich countries agreed at the Kyoto summit in 1997 that it is worrying enough to warrant pre-emptive action. So they have agreed to binding targets to reduce their emissions of greenhouse gases. Whether or how countries will hit these targets is unclear. But demand for oil (though not for cleaner gas) in the rich world is likely to be one casualty.

The supply situation is even gloomier for producers. Unlike 1986, oil supplies have been slow to respond to the past year's fall. Even at \$10 a barrel, it can be worth continuing with projects that already have huge sunk costs. Rapid technological advances have pushed the cost of finding, developing and producing crude oil outside

the Middle East down from over \$25 a barrel (in today's prices) in the 1980s to around \$10 now. Privatisation and deregulation in such places as Argentina, Malaysia and Venezuela have transformed moribund state-owned oil firms. According to Douglas Terreson of Morgan Stanley Dean Witter, an investment bank, this has "unleashed a dozen new Texacos during the 1990s", all of them keen to pump oil.



Meanwhile OPEC, which masterminded the supply cuts that pushed prices up in the 1970s and 1980s, is in complete disarray. The cartel will try yet again to agree upon production cuts at its next meeting, on March 23rd, but, partly thanks to its members' cheating on quotas, the impact of any such cuts will be small. OPEC members fear that Iraq, whose UN-constrained output rose by 1m barrels a day in 1998, may some day be able to raise production further. Last week Algeria's energy minister declared, with only slight exaggeration, that prices might conceivably tumble "to \$2 or \$3 a barrel."

Nor is there much chance of prices rebounding. If they started to, Venezuela, which breaks even at \$7 a barrel, would expand production; at \$10, the Gulf of Mexico would join in; at \$11, the North Sea, and so on (see map). This will limit any price increase in the unlikely event that OPEC rises from the dead. Even in the North Sea, the bare-bottom operating costs have fallen to \$4 a barrel. For the lifetime of such fields firms will continue to crank out oil, even though they are not recouping the sunk costs of exploration and financing. And basket-cases such as Russia and Nigeria are so hopelessly dependent on oil that they may go on producing for some time whatever the price.

	Reserves bn barrels Jan 1st 1999	Production* m barrels per day 1998
Saudi Arabia	262	8.4
Iraq	113	2.1
UAE	98	2.3
Kuwait	97	2.1
Iran	90	3.6
Venezuela	73	3.1
Russia	57	6.9
Mexico	48	3.1
Libya	30	1.4
China	24	3.2
United States	23	6.4
Nigeria	23	2.0

Source: CEPA

*Excludes natural gas liquids

And \$5?

All this explains why oil prices will remain low. But there needs to be a shift in the policy of the world's biggest producer, Saudi Arabia, for them to be halved again. The kingdom has for years restrained output to support prices. However, if its rulers think prices are going to remain low anyway, their calculation may change.

"If it weren't for politics," insists Euan Baird, head of Schlumberger, the world's biggest oil-services firm, "every barrel of oil would be pumped out of the Gulf—especially Saudi Arabia." Politics is not dead yet, as troubles in so many oil countries, from Venezuela to Russia to Nigeria have made plain—indeed, it may be the very prize of oil that has created these countries' problems. But a new kind of politics may now be at work to make Mr Baird's assertion come true.

The latest oil-price shock has come at a sensitive time for the Saudi ruling family. Power is passing from the ailing monarch, King Fahd, to his brother, Abdullah. The autocratic family has had problems with dissent in radical Islamist quarters. Low oil prices crippled the Saudi economy in 1998: output shrank by nearly 2%, both the current-account and the budget deficits soared to nearly 10% of GDP and debt approached 100% of GDP. This year will be worse.

The choice is simple. Either the Saudis must cut back their welfare state, by slashing benefits and raising taxes, or they must find a way of increasing oil revenues. But the ruling family's delicate domestic situation makes the first option difficult. So instead the Saudis may now do what once would have been unthinkable: throw open the taps. That, according to McKinsey, a management consultancy, would certainly herald an era of \$5 oil.

It would also destroy OPEC. But the cartel is already moribund, and unless Saudi Arabia can bring it back from the dead, which is highly unlikely, going for full production is the strategy that makes most sense for all the Gulf states. Mr Elden has crunched the numbers for the five main producers (Saudi Arabia, Kuwait, Iran, Iraq and the United Arab Emirates) at a \$10 price. His analysis shows that after a short period of lost revenues, the Gulf states would enjoy years of strong cash inflow, as they take market share from high-cost regions. He reckons that the real rate of return for the Gulf states

on such an "investment" is 13%, well above the cost of borrowing to plug budget gaps. If Saudi Arabia, on its own, pursues volume, he reckons its rate of return would be an impressive 15%.

The catch is finding the money needed to buy equipment and develop fields now, so as to expand production fast. The strategy Mr Elden suggests of going for full production might cost perhaps \$110 billion, a good \$50 billion more than the Gulf states have to hand. But these countries will not have to beg for charity: their reserves have a present value of \$1.2 trillion. Foreign oil bosses are already queuing up, chequebooks in hand.

Sensitivities about OPEC are one reason why some people doubt that the Saudis will, say, double output to gobble up a 25% share within a few years. Plenty of oilmen think that Saudi Arabia is too cautious for that. The Saudis might instead respond to low prices by increasing output only slowly and quietly. Such a strategy would serve Saudi Arabia's political ends by keeping its chums in OPEC afloat, and its economic ends by forcing many private-sector oil firms to slash output from high-cost, non-OPEC fields.

There are signs that the nationalism of Gulf producers is crumbling. Kuwait is debating opening its oil fields to foreign investment. Even Saudi rulers have dropped some hints. Prince Abdullah, on his first visit to America last autumn, met American oil firms to discuss possible upstream investment in his country, a subject that would once have been taboo. Every few weeks, another top oilman visits the Saudis. Last month, Bill Richardson, America's energy secretary, arrived to woo the royals. Although the Saudis were coy on that occasion, Mr Richardson says he is confident that a framework for upstream foreign investment, beginning with gas, but likely to go on to oil, will be in place within six months.

The good news . . .

One might expect a collapse in oil prices to fuel an orgy of gleeful consumption. Indeed, when the oil price halved in the mid-1980s, world consumption did soar—by 2.7% a year for three years. But not this time, argues Joe Stanislaw of CERA, for two reasons. One is, again, the advance of technology, which has made alternatives to oil, such as natural gas, cheaper. In the mid-1980s oil consumption surged in part because when oil fell below \$20 a barrel, it was often substituted for gas. Now, advances in gas turbines have made gas more attractive, even if oil prices go below \$10.

Another factor is a legacy of previous oil shocks—taxes that are aimed at conservation. In all rich countries but one, taxes make up so much of the price of petrol at the pump that consumers hardly notice any drop in crude prices. In Europe, for example, about 80% of the purchase price (typically, \$1 a litre) is tax. The exception of course, is America, where taxes make up only a third of the price—but at about 40 cents a litre, the price is very low anyway. Philip Verleger, a petroleum economist, reckons that even a prolonged period of low oil prices (below \$10 a barrel) will provide a negligible boost to consumption in OECD countries, perhaps no bigger than 1%.

In poor countries, where taxes are lower and more new power stations and vehicles are being built, the effect of cheaper oil will be greater. Low prices will mean that more poor consumers can enjoy the benefits taken for granted by their rich-world brethren, although that will also mean they produce more greenhouse gases. In places like China, most power now comes from plants using inexpensive, but filthy, coal. Mr Verleger points out that a \$5 world might encourage a shift to oil-fired plants or, better still, to

cleaner ones using natural gas.

... and the bad

Yet a falling oil price will not be good for everyone. In particular, the oil companies and the producer countries will suffer. Low prices have left both screaming in pain—and there may be worse to come.

The six biggest American oil firms posted grim fourth-quarter results for 1998: their after-tax profits fell by 90%, or \$4.8 billion, compared with the same quarter a year earlier. The recent mergers of BP with Amoco and Exxon with Mobil mark a new round of consolidation in the industry. A big motive is to take costs out of the business: Exxon-Mobil for example, expects to save \$2.8 billion from its merger. With its own reorganisation and internal streamlining, Shell is hoping to save \$2.5 billion a year.

The big firms are also expecting Gulf countries to open up to investment and are creating formidable lobbying machines in readiness. This week two European oil firms, ENI and Elf, signed contracts to help develop Iranian oil fields. The new BP-Amoco will take its place near the front of the queue to see Gulf oil ministers, but it will also be able to call on new American friends to put in a good word. Sir John Browne lobbied Mr Richardson before his visit to Saudi Arabia.

If oil companies find that they can adapt, albeit painfully, OPEC countries will find it much harder. The revenues of the cartel's members plunged in 1998 to about \$100 billion, only one-fifth of their 1980 revenues in real terms, according to Marvin Zonis of the University of Chicago. All the oil producers are suffering, but some are in better shape than others. Mexico, for example, has diversified its export base, though the federal government still gets about a third of its revenues from Pemex, the state oil monopoly. Britain has a diversified economy that can weather the price drop. Norway has set aside surplus oil revenues to pay for pensions for its ageing population as oil income wanes. Abu Dhabi and Kuwait, with few people and lots of cash, have been able to stash profits away for rainy days.

But other countries are heading for big trouble. Nearly half of Russia's hard-currency earnings come from crude-oil exports; that figure rises to about 80% for Venezuela and 95% for Nigeria and Algeria. In Russia (and also in the Caspian) low oil prices may make much production unprofitable. In Venezuela, where production costs are lower, the bursting of the oil bubble has helped to propel a populist military man, jailed for two failed coups in 1992, into the presidency. Prolonged low prices could trigger social explosions in several other unstable producing countries.

As for the country that has most ostentatiously frittered away its oil wealth, Nigeria, the delicate transition to democracy that took a further step with last weekend's presidential election (see [article](#)) could yet be undermined by economic troubles. Nigeria is a low-cost producer, so it will still be in business even with low oil prices. But its mismanagement—Nigerians have recently had to queue for two days to get petrol—has been so bad that the transition could prove difficult nonetheless.

In the short run, at least, the oil monarchies of the Gulf could also be in difficulty. Low prices already threaten the delicate "ruling bargain" between dictatorial rulers and coddled subjects. A further plunge in revenues might put them at great risk. If they slash benefits or raise taxes, they risk a backlash that could even shove them out.

In the medium term, however, the Gulf states will find that their revenues recover and even increase with cheaper oil. So once they have made the transition to higher production, a \$5 world should not hold any terrors for them. But it may hold more terrors for the rest of the world—for, just as in 1973, it will find that it is increasingly dependent on a few unstable and unreliable Gulf countries, notably Saudi Arabia, Iran and Iraq, for its energy. Cheap oil may not then look quite so wonderful, after all.

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